



## Luxembourg newflash

11 April 2016

### ESMA publishes discussion paper on UCITS share classes

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On 6 April 2016 ESMA published a second discussion paper on UCITS share classes. The discussion paper builds on the feedback received in relation to ESMA's first discussion paper on this issue which was published in December 2014.

In analysing the responses to the first discussion paper, ESMA has identified diverging national practices as to the types of share class that are permitted, ranging from very simple to much more sophisticated share classes. ESMA is now seeking stakeholders' views on common principles which could form the basis for a regulatory framework that all UCITS share classes should comply with. These common principles are as follows:

- **Common investment objective.** Share classes of the same fund\* should have a common investment objective reflected in a common pool of assets. In particular, ESMA points out that currency risk hedging at the level of a share class should be compatible with the principle of a common investment objective.
- **Non-contagion.** UCITS management companies should implement appropriate procedures to minimise the risk that features which are specific to one share class could have a potentially adverse impact on the other share classes within the same fund. ESMA discusses in particular additional risks introduced by funds with derivative hedging arrangements and requires that such additional risks be mitigated and monitored appropriately and that they may only be borne by investors in the respective share class in the event of materialisation. Accordingly, ESMA discusses the following operational principles to be observed:
  - the notion of the derivative should not lead to a commitment to deliver or receive securities with a value which cannot be serviced by that portion of the common pool of assets on which the share class unitholders have a claim;
  - the UCITS management company should put in place a level of operational segregation which, at a minimum, ensures that there is a clear identification of assets, liabilities and profit/loss to the respective share classes on an ongoing basis (at the very least at the same valuation frequency of the fund);
  - the UCITS management company should implement stress tests to quantify the impact on losses (relating to share class-specific assets that exceed the value of the respective share class) of all investor classes;
  - the UCITS management company should be able to evidence, *ex ante*, that the implementation of a derivative hedge will lead to a share class which better aligns with the specific risk profile of the investor;

- the derivative hedge should be implemented according to a detailed, pre-defined and transparent hedging strategy.

• **Pre-determination.** All features of the share class should be pre-determined before it is set up in order to allow the potential investor in the fund to gain a full overview of the rights and/or features attributed to his investment. In share classes with hedging arrangements, this pre-determination should also apply to the kinds of risk which are to be hedged out systematically. ESMA furthermore is of the opinion that a share class offering any form of discretion to the UCITS management company with regard to hedging mechanisms would contravene this principle.

• **Transparency.** Differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes. With regard to share classes with a contagion risk, ESMA is of the view that the UCITS management company should provide a list of share classes in the form of readily available information which should be kept up-to-date and that stress tests should be made available to national competent authorities.

While discussing the above-mentioned common principles, it should be noted that ESMA seems to approve the existence of share classes with currency hedging. However, ESMA raises doubts as to whether duration-risk-hedged or volatility-risk-hedged share classes would be compatible with these principles.

The consultation period for this second discussion paper closes on 6 June 2016. According to a relevant press release, ESMA expects to take further action on UCITS share classes by the end of 2016.

[The discussion paper may be downloaded here.](#)

We remain at your disposal for any further questions.

\* For the purposes of the discussion paper, the term "fund" should be understood to refer to a UCITS fund or one or more of its sub-funds.

This publication is intended to provide information on recent legal developments and does not cover every aspect of the topics with which it deals. It was not designed to provide legal or other advice and it does not substitute for the consultation with legal counsel before any actual undertakings.

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